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SUPREME COURT OF THE UNITED STATES

October term 1996

MICHAEL L. ALLEN and	)
ANN MARIE ALLEN,	)
Petitioners,	)
	)
versus	)
	)
COMMISSIONER OF INTERNAL REVENUE,	)
Respondent.	)

On Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED FOR REVIEW

Was the I.R.S. determination of the income tax deficiency for 1981 and 1983 arbitrary and excessive because the I.R.S. used the $790,000 sale of the *Norem property* in May 22, 1986 as its reference point for determining the fair market value of the *Venture Inn* exchange property in 1981? If so, the Tax Court and the Ninth Circuit should have shifted the burden of proof on the respondent.

LIST OF PARTIES

The petitioners are Michael L. Allen and Ann Marie Allen.

The respondent is the Commissioner of Internal Revenue (referred to herein as the I.R.S.).

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STATEMENT OF JURISDICTION

This is a petition for a writ of certiorari for the purpose of reviewing an adverse determination of a person's liability for the federal income taxes.

predicates for appeal

The order to be reviewed is an adverse decision by the Circuit Court of Appeals for the Ninth Circuit, dated October 23, 1996 (see Appendix), followed by a denial of the petitioners' petition for rehearing before the Court of Appeals for the Ninth Circuit. The denial order was dated December 26, 1996 (see appendix).

statutory basis for jurisdiction

Jurisdiction is conferred under Int. Rev. Code §7482(a)(1) and Title 28 §1254. The ninety day period for appeal expires on March 26, 1997, ninety days following a denial of the petitioners' motion for rehearing.

statement notification to party

The Solicitor General of the United States and the Internal Revenue Service have been notified of this appeal, as indicated by the Certificate of Service.

CONSTITUTIONAL PROVISIONS, TREATIES, STATUTES, ORDINANCES AND REGULATIONS

Title 26 USC § 7453
Rules of practice, procedure, and evidence.
Except in the case of proceedings conducted under section 7463, the proceedings of the Tax Court and its divisions shall be conducted in accordance with such rules of practice and procedure (other than rules of evidence) as the Tax Court may prescribe and in accordance with the rules of evidence applicable in trials without a jury in the United States District Court of the District of Columbia.

Tax Court Rule of Rules of Practice and Procedure
TAX COURT RULE 142. BURDEN OF PROOF
(a) General:
The burden of proof shall be upon the petitioner, except as otherwise provided by statute or determined by the Court...

STATEMENT OF CASE

This appeal is limited to the burden of proof issue, raised in the initial proceedings in the Tax Court and on appeal before the Ninth Circuit. The burden of proof issue relates to an arbitrary and excessive determination of an income tax deficiency by the I.R.S. Specifically, in determining the extent of a taxable distribution of the *Venture Inn* motel from *TVI* (an S corporation) to its sole shareholder (petitioner Michael Allen), the I.R.S. made an arbitrary and excessive determination of the November 15, 1981 fair market value of the *Venture Inn* by reconstructing the fair market value of the *Venture Inn* by reference to the May 22, 1986 gross selling price of the *Norem Property*, a property that the petitioner had received in a tax free exchange for the *Venture Inn* on November 15, 1981. The I.R.S. could have used either of two logical reference points from which a rational determination of value could have been made, (1) the value received from a subsequent repossession of the *Venture Inn* by a creditor; or alternatively, (2) the value paid to third parties for the *Norem Property* at the time of the exchange. In addition, the I.R.S. ignored the change in the fair market value of the *Norem Property* between the November 15, 1981 exchange date and its subsequent disposition on May 22, 1986, as the result of the purging of a negative cash flow lease.

jurisdictional basis of lower court of review

This is an appeal from an adverse decision by the United States Court of Appeals for the Ninth Circuit, a court of review over the United States Tax Court, the court of original jurisdiction in this case. See Int. Rev. Code §7482(a)(1) and §7442.

FACTS MATERIAL TO QUESTION PRESENTED

For convenience, the below-italicized terms represent the following:[1]

Allen *Dr. Allen*	the petitioner Dr. Michael L. Allen, individually
the Allens	both the petitioner Dr. Michael L. Allen and his wife, the petitioner Ann Marie Allen
Berja Investments	a partnership, owned 50% by "Jackson" and 50% by "Berlin," which owned the "Norem Property" which was transferred to "the Allens"
Berlin	Joseph T. Berlin, "Jackson's" 50% partner in "Berja Investments"
the Chapmans	Robert P. and Patricia J. Chapman, the parties who sold the "Venture Inn" motel to "Allen" (who later transferred it to "TVI"); see "Chapmans K"
Chapman K	"the Chapmans" contract for deed, transferring their ownership rights to the "Venture Inn" to "Allen" who then assigned his rights to "TVI", "Allen's" wholly-owned S corp

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[1] These glossarized definitions are identical to those used throughout petitioners' briefs to the Tax Court and Ninth Circuit.

the Cummings — Hugh G. and Alice I. Cumming, the parties who sold the "Venture Inn" parking lot to "the Allens"; see "Cummings' K"

Cummings K — "Cummings'" contract for deed (dated 17 October 1977) transferring their ownership of the land, which "the Allens" converted into a parking lot, adjoining the newly expanded "Venture Inn" to "the Allens"

Exchange Agreement — the Real Estate Exchange Agreement which contemplated a Starker-like exchange between "TVI" and "the Allens" (the first parties) for "Parcels A and B" in exchange for "Jackson's" (the second party) for "Parcel C" and other property to be later identified and obtained by "Jackson."
executed on October 1, 1980

IMA — Imperial Motel Associates, an unincorporated entity in whose name "Jackson" conducted his business

Jackson — Paul M. Jackson, d/b/a as "IMA," who tried to obtain the "Venture Inn" from "TVI" and "Allen" through the "Exchange Agreement"

Lence
Mr. Lence
John A. Lence, a Kalispell attorney who represented the parties in the transactions involving "TVI", "the Allens," and "Jackson."

Norem Property
a commercial building which was used as an auto dealer's facility in Bozeman, Montana and was transferred to the "Allens" by "Berja Associates"

Parcel A
commonly referred to in the various documents as Schedule A Property, which is the "Venture Inn" motel, which "the Allens" had initially acquired from "the Chapmans" under a contract for deed which they then assigned to "TVI", and also includes its "SBA" financed addition, but does not include the adjoining parking lot.
parcel a is more fully described in the plat attached to this Glossary.

Parcel B
commonly referred to in the various documents as Schedule B Property, which is the "Venture Inn" parking lot, that "the Allens"' had initially acquired by contract for deed from the Cummings but did not transfer to "TVI".
parcel B is more fully described in the plat attached to this Glossary.

Parcel C	commonly referred to in the various documents as Schedule C Property, which was Lincoln County, Montana ranch property to be acquired by Jackson for implementing part of the exchange agreement
SBA	the Small Business Administration
TVI	"Allen's" S corporation, named The Venture Inn, as distinguished from the motel, itself, which is referred to as the "Venture Inn".
Venture Inn	the motel, restaurant, and casino which was "TVI"'s only business and principal asset

The following facts are not disputed and are consistent with those determined by the fact finder:

The I.R.S. determined that on November 15, 1981, *Allen* exchanged the *Venture Inn* for the *Norem Property* in a tax free exchange with *Jackson*. Since *Allen* never held title to the *Venture Inn,* the I.R.S. determined that *Allen* had to have constructively received the *Venture Inn* from *TVI* (his wholly owned S corporation) in order to consummate the tax free exchange. For tax purposes, the I.R.S. measured the value of the constructive distribution to *Allen* by first determining the fair market value of the *Venture Inn* at the time of distribution (November 15, 1981) and then subtracting the amount of encumbrances assumed by *Allen* on the transfer. The amount of encumbrances is not in dispute. Only the fair market value of the *Venture Inn* at the time of exchange is in dispute.

Mechanically, the I.R.S. determined the November 15, 1981 fair market value of the *Venture Inn* as follows:[2] [3]

gross sales price for *Norem Property* on May 22, 1986	$790,000
less: debts assumed by *Allen* on his acquisition of the *Norem Property* on November 15, 1981	-662,032
the I.R.S.' back-dated fair market value of *Allen's* equity the *Norem property* at the time of acquisition on November 15, 1981.	$127,968
plus, the liabilities *Allen* assumed on his constructive acquisition of the *Venture Inn* from *TVI*.	1,427,067
the I.R.S. determined fair market value of the *Venture Inn* on November 15, 1981.	$1,555,035

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[2] This appeal is limited to the arbitrariness of the respondent's determination of the fair market value of the *Venture Inn*. All other issues have been conceded.

[3] Exhibits 4 and 5 to the I.R.S. deficiency notice (EXHIBIT 8-H, pp. 33-34) recognize the interdependence between the exchange and a determination of the adjusted basis of *Allen's Norem property*. However, Exhibit 5 erroneously understates the total of $1,555,035 and $662,037 by $40,000, an error that respondent conceded and that erroneous adjustment is not in dispute.

On his 1981 joint tax return for purpose of claiming depreciation, *Allen* reported $662,032 as his basis in the *Norem Property* and not $790,000, as later determined by the I.R.S.

On his 1986 joint tax return, *Allen* reported $790,000 as the amount he realized (before reduction for selling costs) from the resale of the *Norem property* back to Don Norem. After subtracting his depreciated cost basis and selling expenses of $38,000, *Allen* reported and paid income tax in 1986 on his resulting $113,699 long-term capital gain.[4] [5] [Exhibits. BG, BF and 66].

At the time of the November 15, 1981 exchange, B*erja Associates* gave up its interest in the *Norem Property* solely for relief from $662,032 in encumbrances. *Allen* agreed to assume that debt. The exchange with *Berja Associates* was at arms length. This is because although *Jackson* (a 50% *Berja Associates* partner) was both a party to the exchange with *Allen*, *Berlin* (also 50% *Berja Associates* partner) was not. The record indicates without contradiction that neither *Berja Associates* nor *Berlin* received any additional consideration other than relief from the $662,032 in the debts then encumbering the *Norem Property*.

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[4] Approximately two-thirds ($80,544) represented *Allen's* recovery of depreciation that he had claimed over the previous 54 months and the remainder represented a modest appreciation in his investment.

[5] The I.R.S. notice of deficiency allowed *Allen* a corresponding increase in his 1981 basis of the *Norem Property* and a corresponding increase in his claimed depreciation.

All of the above facts are consistent with the findings of the trial judge and as have been upheld by the Ninth Circuit. [See court opinions in Appendix)

At trial, *Jackson* testified:

Q. Did Berja Investments have anything to do with Venture Inn?

A. Prior to the involvement of Mr. Allen?

Q. Right.

A. No; not to my knowledge.

Q. Did Mr. Berlin, as a partner of Berja Investments, ever receive any rights or interest to the property called the Venture Inn property?

A. Not to my knowledge.

Q. You know where Mr. Berlin is today?

A. I do not. I have not talked to him in six years.

[Transcript 163]

In addition, at the time of the exchange, the *Norem Property* was encumbered by an adverse 5 year lease with a 5 year renewal that created a negative $20,000 per year cash flow. After the exchange, the *Norem property* became increasingly more valuable as it became progressively unencumbered from the adverse negative cash-flow lease. At trial, *Lence* testified:

Q. Did you believe the property had a value of that in 1981?

A. Well, it was subsequently encumbered with a long-term bargain lease in favor of the tenant that substantially stripped the value of the Norem property prior to the acquisition by Dr. Allen. So no, I didn't believe it.

Q. How were you familiar with this long-term lease?

A. I was given a copy of it.

MR. MORRISON: In fact, I'm going to ask you to stipulate this lease, Mr. Ritter. I don't think it's in the record.

MR. RITTER: I so stipulate to it; yes.

(The document referred to was marked Petitioners' Exhibit 70.)

THE CLERK: Petitioners' Exhibit 70 marked for identification.

MR. MORRISON: Thank you.

BY MR. MORRISON:

Q. Mr. Lence, are you familiar with Exhibit 70?

A. Yes, I am.

Q. Is that the long-term lease you just referred to in your prior testimony?

A. Yes, it is.

Q. And how -- tell me what significance that lease had in -- or, what circumstances it -- tell me the circumstances under which you were familiar with that document and what would it signify to you in advising your client.

A. Well, at the time that Allen was considering acquiring through purchase or exchange this particular property, I advised Dr. Allen to verify what the negative or positive cash flow of the underlying lease would be, based on the payments that were due on the underlying debt, together with any other expenses such as repair, maintenance, insurance, and taxes.

This lease was a ten-year lease -- five years, with a right for the tenant to renew for five years. I determined that the negative cash flow was approximately $20,000 per year on the property. Aside from depreciation, it was 20,000 of actual cash flow loss per year.

[Transcript 91-93]

In the following year, 1982, the *Venture Inn* was eventually repossessed by the *Chapmans*, in default of either *Allen* or

Jackson being able to continue making purchase-money payments. Neither *Jackson* nor *Allen* nor *TVI* received any additional consideration at the time of the repossession. As the parties stipulated, *Allen* relinquished *TVI*'s interest in the *Venture Inn*, along with his personally owned parking lot (*Parcel B*) in exchange for relief from all indebtedness and for no other consideration.

> *From August 16, 1982 through August 30, 1982, various documents were signed unraveling the various transactions regarding the "Venture Inn", the end result which was the return of the property to "the Chapmans." "The Chapmans" assumed all debt on the "Venture Inn" as set forth in (Joint Exhibit 49-AW). Joint Exhibit 51-AY contains the various documentation prepared and signed which completed the transfer of the "Venture Inn" back to "the Chapmans."*
>
> [First Trial Stipulation ¶54]

Allen, himself, testified:

Q. Did the Chapmans finally repossess your property?

A. In the long run, Chapman ended up with the Venture Motor Inn, yes. Out of -- I -- it went through the bankruptcy, and then I think he got it back from the bankruptcy.

Q. At that time, you were willing to give him your interest -- personal interest in Parcel B, incident to his repossession.

A. I was -- I was happy to give up that property for getting out of, first, the SBA 350,000, which whatever the balance was, Chapman had to pay off. And he took me out of all underlaying debt in that particular time.

Q. So might I assume that when Chapman did the repossession, that he agreed that he wouldn't go after you for any deficiency judgments?

A. That's correct.

Q. And was that the reason that then you were willing to –

A. Yes.

Q. – let him assume the debt on your Cummings property parking lot?

A. Yes. He assumed the balance of that debt on that also.

Q. So to put it another way, the quid pro quo for you giving up your ace in the hole, as you mentioned –

A. That's right.

Q. – was to get relieved from that debt –

A. That was –

Q. – without a deficiency judgment on your neck.

[Transcript 229-230]

Lence also testified:

A. Crocker[6] *determined, as I understood, that the property had no value in excess of its debt and, as a consequence, he instead went to the bankruptcy court to request a release of the stay, to obtain the property back from the bankruptcy court and all of the participants, and clear the clouds on the title. He thus avoided having to pay the $100,000-plus debt assumption referred to in the earnest money agreement.*

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[6] Crocker was *Chapmans'* attorney. [See Tr. 79]

Again *Lence* testified:

THE WITNESS: The -- this automatic stay lifted, because the creditors committee determined that there was no equity in the property over and above the debt.

[See Transcript 85-86]

Q. And what was -- what was the reason after -- Mr. Jackson had already been in a Chapter 11 bankruptcy. What reason, what objective would benefit Dr. Allen by releasing all the documents that you were holding in this informal escrow?

A. I believe that, in view of the excessive debt on the Venture Motor Inn property and Dr. Allen's personal liability, that he wanted somehow to be relieved of that debt. And he wanted, in effect, not to be personally liable and have his empire crumble through foreclosure.

Q. How did he -- how did you think that could be accomplished by turning the property over to Jackson, and all these deeds to Parmelee and Ostel that Jackson tried to roll it over to, and have all this under the umbrella of the bankruptcy court? How would that accomplish that objective? What was perceived?

A. Number one, I think a federal stay would have protected the property, if it had equity. It was later determined not to have. And number two, I really, truly believe that Dr. Allen was trying to help Paul Jackson maintain his viability in the Chapter 11 so that he could accomplish for Dr. Allen the promises that he had made in 1980 pursuant to the open Starker. In other words, the heath and economic health of Jackson was important to Allen.

Q. Would it be fair to say that all these transfers that were done, what we've called the unraveling, on

March 20th, 1982 were essentially contingent upon the bankruptcy court's accepting this property as having equity in the Chapter 11?

A. That's a fair statement.

Q. But for that, would it be fair to say that the exercise of recording all those deeds was a fairly meaningless gesture?

A. Yeah; I -- yes, I think Jackson was insolvent.

Q. Were there ever, to your knowledge, any deeds prepared conveying the Parcel A of the Venture Inn to Dr. Allen from his corporation?

A. You mean the actual motel facility?

Q. Right; what we call -- what we've been referring to as parcel -- not Parcel B, but Parcel A.

A. There was never a deed ever prepared or ever executed between the Venture Motor Inn, Inc., transferring title or trying to transfer, purporting to transfer title to Dr. Allen.

[See Transcript 131-134]

Jackson then testified:

Q. Well, do you think that it had any value above the debt?

A. No, I did not.

Q. Was the stay lifted over the Venture Motor Inn?

A. Yes, it was.

[See Transcript 174]

There is no dispute that other than relief from personal and corporate debts and loan guarantees, *Allen* never received an additional cent from the *Chapmans*, when he agreed to surrender all of his interest in *TVI's Venture Inn* motel and his personally owned parking lot (*Parcel B*). Since the *Chapmans* had never owned *Parcel B*, their dealings with *Allen* were at arm's length and in substance an arm's length purchase.

ARGUMENT FOR WRIT

The I.R.S. determined that on November 15, 1981, *Allen* received a constructive distribution from *TVI*. This determination was arbitrary and excessive. This is so because the I.R.S. irrationally determined the November 15, 1981, fair market value of the *Venture Inn* by referring to the May 22, 1986, selling price for the *Norem Property*. In doing so, the I.R.S. erroneously created an artificial equity in the *Venture Inn* which became the source of its unfair income tax adjustment against the petitioners.[7]

Because of the arbitrary and excessive I.R.S. conduct, the I.R.S. should be required to bear the burden of proving that on November 15, 1981, *Allen* received a constructive distribution of any value.

The arbitrary and excessive burden-of-proof issue was clearly defined by this Court in of *Helvering v. Taylor*, 293 U.S. 507, 14 AFTR 1194, 55 S Ct. 287, 79 L. Ed. 623, 35-1 USTC ¶9044 (1934).

The actual facts in the frequently cited *Taylor* case, *supra* at p.16, are rarely discussed. But ironically, the facts in this case are remarkably similar to those in *Taylor* and make it unnecessary to dwell on other cases of less relevance.

In *Taylor*, the taxpayer purchased all of the stock in four utility companies for $96,030 on August 1927. Two months later (October 1927), the taxpayer exchanged the stock in the four utility companies for all of the stock of his newly created,

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[7] For the purpose of this appeal, the petitioners do not dispute that *Allen* constructively received the *Venture Inn* and do not dispute that *Allen* exchanged the *Venture Inn* with *Jackson* for the *Norem Property*.

wholly owned holding company. In exchange, the taxpayer took-back 1000 shares of preferred and 2500 shares of common stock in the holding company. This exchange was treated as a tax-free reorganization. Nine months after the purchase of the four utility companies (May 1928), the taxpayer directed his holding company to sell the stock in its four utility companies for $194,930. Later in the same year, the taxpayer redeemed his preferred stock in the holding company for $99,000, leaving him with the 2,500 shares of common. In reporting his gain from the redemption, the taxpayer assigned all of his original $96,030 purchase price to his 1000 shares of preferred and none to his 2,500 shares of common. Consequently, on the disposition of his preferred stock, the taxpayer reported a net gain of $2,970 ($99,000 less $96,030). The I.R.S. redetermined the taxpayer's basis in his preferred stock by assuming the subsequent $194,930 gross sales price for the four utility companies was representative of the combined fair market value of the holding company's common and preferred stock at the time it had been issued in October 1927. The I.R.S. then assumed that the $99,000 paid in redemption of the taxpayer's preferred stock was similarly representative of the total fair market value of the preferred at the time it had been issued in October 1927. From these two assumptions, the I.R.S. then reconstructed the taxpayer's basis in the common and preferred stock by allocating the taxpayer's $96,030 original acquisition cost to the preferred, as follows:

$99,000.00 (redemption proceeds for the preferred) / $194,930.16 (selling price for the four utility companies)	x	$96,030.00 (taxpayer's original cost)	=	48,771.16 (reconstructed basis for the preferred)

(see *Taylor*, at footnote 2)

In *Taylor,* supra at p.16, Justice Butler stated at 14 AFTR 1198:

> *...But, where as in this case, the taxpayer's evidence shows the Commissioner's determination to be arbitrary and excessive, it may not reasonably be held that he is bound to pay a tax that confessedly he does not owe, unless his evidence was sufficient also to establish the correct amount that lawfully might be charged against him. On the facts shown by the taxpayer in this case, the Board should have held the apportionment arbitrary and the Commissioner's determination invalid. Then, upon appropriate application that further hearing be had, it should have heard evidence to show whether a fair apportionment might be made and, if so, the correct amount of the tax. The rule for which the Commissioner here contends is not consonant with the great remedial purposes of the legislation creating the Board of Tax Appeals.[Footnote 5] The Circuit Court of Appeals rightly reversed and remanded the case for further proceedings in accordance with its opinion.*

No one could dispute the Commissioner's logic, if all of these transactions had occurred within a few hours or days. But this Court disregarded the Commissioner's assumption that the 1928 sale of the four holding companies for $194,930.16 had any relevance in determining the relative the fair market values of the preferred and common stock nine months earlier in 1927.

The reference points for determining value

In this case, to fully understand the arbitrary and excessive issue, it is helpful to understand the available reference points in the record from which the November 15, 1981 fair market value of the *Venture Inn* could have been determined. There are three reference points:

1. the consideration given on the repossession of the *Venture Inn* a few months after the November 15, 1981 exchange.
2. the consideration paid to *Berja Associates* for the *Norem Property* on November 15, 1981, the date of the exchange.
3. the irrelevant gross selling price of the *Norem Property* on May 22, 1986, four years and six months after the November 15, 1981 exchange.

Reference point 1-

the consideration given on the repossession of the *Venture Inn* a few months after the November 15, 1981 exchange.

The first reference point focuses on the direct value of the property *Allen* surrendered in the exchange (the *Venture Inn*), which can be ascertained from the facts subsequent to the exchange. What ultimately happened, as no one can dispute, is that within a few months after the exchange, the *Chapmans* (the original purchase money sellers) repossessed the *Venture Inn*, because neither *Allen* nor *Jackson* could make the required purchase money payments. This event demonstrates and reinforces petitioners' contention that the *Venture Inn* had no value greater than the indebtedness encumbering it and for the purpose of this case, it is not necessary to determine the extent to which it had a lesser value, because if the *Venture Inn* had no value greater than its encumbrances, *Allen* received the property solely by purchase and not from a corporate distribution to a shareholder.

Reference point 2-
the consideration paid to *Berja Associates* for the *Norem Property* on November 15, 1981, the date of the exchange.
The second reference point focuses on the value of the property *Allen* received in the exchange (the *Norem Property*) in order to measure the fair market value of the property he surrendered (the *Venture Inn*). This is the approach initially taken by the I.R.S. and to this extent the logic of the I.R.S. is not faulty.

The sale of the *Norem Property* by *Berja Associates* was at arms length, because one of its 50% partners, *Berlin,* was not involved in the exchange with *Allen*. No other consideration was paid to *Berja Associates* other than relief from $662,032 in encumbrances and that was the amount *Allen* claimed as his basis in the property. *Jackson* may have been able to consummate his exchange with *Allen* by causing *Berja Associates* to swap the *Norem Property* on his behalf for the *Venture Inn*, but *Berlin* received no interest in the *Venture Inn* and received no consideration out of the exchange other than for being relieved from his ½ share of *Berja Associates'* $662,032 indebtedness. This consequence gave substantive meaning to the consideration given in the exchange for the *Norem Property* and the significance of this consequence for the purpose of determining the value of properties in 1981 was far greater than what the *Norem Property* sold for in 1986!

Reference point 3-
the irrelevant gross selling price of the *Norem Property* on May 22, 1986, four years and six months after the November 15, 1981 exchange.

The third reference point is the consideration given to *Allen* for the *Norem Property* on May 22, 1986. This reference point requires an irrational assumption that the fair market value of the *Norem Property* on May 22, 1986, was the same as its fair market value on November 15,.1981, when it was traded to *Allen* for the *Venture Inn*. This faulty assumption requires an even greater deviation from the impermissible jump the I.R.S. took in the *Taylor* case, *supra* at p.16.

Subsequent year real estate values can not be assumed to remain static. In *Taylor*, the intervention of changing circumstances was an important factor, as it should also be in this case. In this case, both the Ninth Circuit Court and the Tax Court erroneously failed to acknowledge the existence of changing circumstances; such as, the year by year purging of a negative cash flow lease encumbering the *Norem Property*.

The logical consequence of *Lence's* testimony (set forth above) is that even if during the four and one-half year period that *Allen* owned the *Norem Property*, the fair market value of the *Norem property* remained static, its overall fair market value would have increased as the result of the shortening of period being burdened by the adverse lease. In addition, this Court can take judicial notice that real estate values rarely remain static over a sustained period of time.

Also as indicated, *Allen* reported a $113,699 long-term capital gain attributable to his disposition of the *Norem Property* on May 22, 1986! This reported gain would not have been realized, if *Allen* had valued his *Norem Property* in 1981, as the I.R.S. subsequently valued it. More ironically, *Allen's* reported 1986 capital gain was substantially

attributable to his loss of basis due to depreciation during the years he owned the *Norem Property*. This Court can also take judicial notice that depreciable real estate does not lose value precisely in the same manner that it is depreciated for tax purposes.

In comparison with *Taylor, supra* at p.16, the I.R.S. methodology in this case was far more excessive and unreasonable. In comparison, in *Taylor* the I.R.S. retroactive valuation stretched 9 months. In contrast, in this case the I.R.S. retroactive valuation stretched 54 months, from November 15, 1981 to May 22, 1986!

In this case, in order to impose its back-dated valuation methodology, the I.R.S. blindly ignored the factual reality of the consequence of the *Chapmans'* repossession of the *Venture Inn* only a few months after the exchange was consummated.[8]

In this case, in order to impose its back-dated valuation methodology, the I.R.S. blindly ignored the factual reality of the consequence of the *Berja Associates'* relinquishment of the *Norem Property* for no consideration other than the relief from debts, then encumbering it..[9]

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[8] See the 1977 *Chapman-Allen* Contract for Deed, EXHIBIT 10-J; the Notice of Purchaser's interest, EXHIBIT 11-K; the quitclaim deeds of relinquishment of the *Venture Inn* to the *Chapmans*, EXHIBIT 51-AY, pp. 54-57; and the 1986 *Norem* sales contract, EXHIBIT 61-BI, pp. 1-9.

[9] See the 1977 *Chapman-Allen* Contract for Deed, EXHIBIT 10-J; the Notice of Purchaser's interest, EXHIBIT 11-K; the quitclaim deeds of relinquishment of the *Venture Inn* to the *Chapmans*, EXHIBIT 51-AY, pp. 54-57; and the 1986 *Norem* sales contract, EXHIBIT 61-BI, pp. 1-9.

the arbitrariness of the I.R.S. methodology

Although the I.R.S. impressed the trial court, by explaining how it had given the taxpayer a break by using its most conservative determination of value, the I.R.S. did not offer any evidence in corroboration. And even if other credible bases for making a rational determination were available, the I.R.S.' should not be allowed to impose the arbitrary valuation methodology that it did use. More simply, the I.R.S. can not be allowed to salvage its unreasonable determination by its silence.

To better understand the I.R.S. methodology, I.R.S. Appeals Officer Anita Teichrow explained:

> *THE WITNESS: Okay. The initial number that, it appears from the work paper file, that the examiner was provided was a fair market value of 1.1 million...*
>
> *THE WITNESS: Subsequent to that time we were advised that the fair market value of the Norem building was 1.75 million. However, during the course of the examination it appeared, because the Norem building was up for sale, that the $1.1 million was far in excess of what the real fair market value of that building might be. So the examiner used the $790,000 figure in his report as opposed to the $1.1 million, because that did not appear to be perhaps a reasonable basis for determining fair market value in this case. I don't know what his reasons were but, nevertheless, he took the conservative figure that he had for value provided by Mr. Lence to him.*
>
> [Transcript pp. 59-60, underscoring added]

Q. The question is simply the -- that the amount realized that was determined by the IRS in arriving at its

adjustment from the gain or loss, the dividend issue, the 301 -- the amount realized on the -- on the Venture Inn property was predicated upon using the $790,000 selling price of the Norem property? You backed into the amount realized from the Venture Inn disposition by using the selling price of the -- the $790,000 selling price in 1986? Isn't that correct?

A. In order to determine a fair market value of the Venture Motor Inn, I would have to say that that is probably true.

Q. Why do you not say it's not -- why do you say "probably true"? The tax return show that -- you admit the tax return --

THE COURT: Well, let me ask the witness. How is it you arrived at the -- would you describe for us, if you remember, how you arrived at the figure that he's asking about, the 790,000? How did you do that?

THE WITNESS: Well, there's a lot of figures that were thrown around, and we had to come up -- I didn't do this. This was at the Exam level.

THE COURT: Well, do you know how it was arrived at?

THE WITNESS: The fair market value? Yes, I do. I think so.

THE COURT: Would you describe how you understand it was arrived at?

THE WITNESS: The fair market value of the Venture Inn assets were arrived at by determining what the outstanding liabilities of the corporation were at the date the exchange was entered into, added to the difference between the fair market value of the Norem property received in the exchange, less the adjusted basis of the assets in the Norem building that was received.

BY MR. MORRISON:

Q. But the question is in determining the – and in doing that, in determining the fair market value of the Norem property, you used the selling price in 1986?

A. That is correct.

Q. So the bottom line is, you backed into the fair market value of the Venture Inn property by reference to the 1986 value of the Norem selling price? That has to be correct.

A. If that's the way you want to term it –

Q. Well –

A. – that's the way you can term it.

Q. I'm asking you, isn't that so?

A. I told you how we determined it. We took the fair market value of the Norem building, less the liabilities of the Norem building, came up with a value.

Q. But you took the 1986 fair market value of the Norem building –

A. That is right.

Q. – in determining its 1981 value-

[Transcript pp. 61-63]

Logically, if I.R.S. had increased its determination of the fair market value to an even higher number, the consequence would be to have caused *Allen* to suffer an even greater artificial loss on the disposition of his *Norem Property* in 1986 in comparison with his reported a $113,699 long-term capital gain attributable to his disposition of the *Norem Property* on May 22, 1986! If the I.R.S. determination of the November 15, 1981 fair market value of the *Norem Property* were correct, then for the I.R.S. to be consistent, the I.R.S. would admit that *Allen* overstated his 1986 gain on the disposition of the *Norem Property* by $127,968 (less the small incremental increase in depreciation during the interim years that would be attributable to the I.R.S. increase in the initial

fair market value of the *Norem Property*). In other words to sustain the I.R.S. determination that *Allen* realized a bigger profit in 1981, the consequence would be that *Allen* had to have realized a loss in 1986. Yet there is nothing in the record to justify such an absurd consequence.

In spite of Ms. Teichrow's intimation, the I.R.S. restraint in redetermining the November 15, 1981 fair market value of either the *Venture Inn* or the *Norem Property* was not an act of generosity toward the petitioners. Ms. Teichrow admitted other indicators of greater values were arbitrary. More simply, the I.R.S. knew it could not justify determining value by its other more dubious information..

The futility of an appraisal

It was both needless and superfluous for the petitioners to have obtained and introduced a corroborative appraisal of the fair market value of the fair market value of the *Venture Inn* at the time of the trial in 1992, more than 10 years after the event. This is so, because the actual consideration received by the sellers of the *Norem Property* in 1981 leaves the issue of value unambiguous, as well as the corroborative consideration given for the reacquisition of the *Venture Inn* by the *Chapmans.*

The Ninth Circuit erroneously implies without so stating that such an appraisal should have been obtained in order for *Allen* to prevail on the burden-of-proof issue. Yet no after-the-fact appraisal could have had greater significance that the actual consideration given for these properties on or near the November 15, 1981, valuation date. The I.R.S. should not be allowed to now ignore these relevant facts and resort to its own dubious methodology for redetermining the November 15, 1981, fair market value of the *Venture Inn* .

Unfairness of *Allen's* paying tax twice on the same gain

With the benefit of hindsight, the I.R.S. used the May 22, 1986 sale of the *Norem property* to create its unfair dividend distribution adjustment in 1981.[10] To accomplish its absurd dividend adjustment in 1981, the I.R.S. had to determine that *Allen* erroneously over-reported a 1986 long-term capital gain from the disposition of his *Norem property*, because his 1986 profit should have been derivative from the his 1981 exchange of the *Venture Inn* for the *Norem Property*. The respondent's own notice of deficiency shows gratuitous I.R.S. adjustments, which increase *Allen's* depreciation for his *Norem Property* as a result of the phony increase in its 1981 fair market value.

SUMMARY OF ARGUMENT

In our free and democratic society, the I.R.S. should, as should any person or government agency, be made accountable. The I.R.S. must not be free from acting responsibly. The I.R.S. must not be free to burden taxpayers unfairly with irrational income tax adjustments. Such was this Court's holding in the *Taylor* case, *supra* at p.16.

If the principle in *Taylor* case were applied to the outcome of this case, the I.R.S. would be required to bear the burden of offering its own proof of what should be the fair market value of the *Venture Inn* on November 15, 1981, when *Allen* exchanged it for the *Norem Property*. Petitioners respectfully submit that if the I.R.S. were so required, it could not produce any evidence to show that the fair market value of

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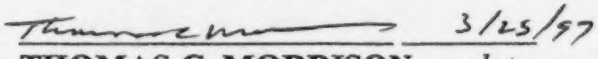
[10] In the lower courts, the purported exchange of the *Venture Inn* for the *Norem property* was questioned as being legally impossible as well as factually frustrated. For the purpose of this appeal, this issue is not being challenged.

either the *Venture Inn* nor the *Norem Property* exceeded the debts encumbering them at the time of the exchange.

This is a tax case. It is important for this Court to intercede so that the American judicial process will properly protect not only the petitioners in this case, but all American citizens from an otherwise out-of-control, arbitrary and oppressive government.

For the above reasons, it is respectfully requested that this Court remand this case for the purpose of requiring the I.R.S. to assume its deserved burden of proving the fair market value of the *Venture Inn* was other than what the petitioners claimed it to be.

Respectfully submitted:



3/25/97

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SUPREME COURT OF THE UNITED STATES

October term 1996

MICHAEL L. ALLEN and	)
ANN MARIE ALLEN,	)
Petitioners,	)
	)
versus	)
	)
COMMISSIONER OF INTERNAL REVENUE,	)
Respondent.	)

On Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

APPENDIX TO PETITION FOR WRIT OF CERTIORARI

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Opinion of the Court of Appeals for the Ninth Circuit and related orders

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

MICHAEL L. ALLEN;
ANN MARIE ALLEN,
Petitioners-Appellants,

v.

COMMISIONER OF
INTERNAL REVENUE
Respondent-Appellee,

No. 94-70490

Tax Ct. No.S567-91

MEMORANDUM*

Appeal from the United States Tax Court
Joel Gerber, Tax Court Judge, Presiding

Argued and Submitted October 7, 1996
Seattle, Washington

Before: BROWNING, D.W. NELSON, and FERNANDEZ, Circuit Judges

Michael Allen and Ann Marie Allen appeal the Tax Court's redetermination of

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* This disposition is not appropriate for publication and may not be cited to or by the courts of this circuit except as provided by 9th Cir. r. 36-3.

their federal income tax deficiencies for tax years 1980, 1981, and 1983. We affirm.

1. The Allens first contend that the Tax Court erred when it decided that the Venture Inn had been exchanged for the Norem Building. Consequently, the Allens aver that the Tax Court mistakenly concluded that there had been a constructive distribution of the Venture Inn. That kind of determination by the Tax Court involves both questions of historical fact and questions of law. See Sacks v. Commissioner, 69 F.3d 982, 986 (9th Cir. 1995). We review the former for clear error and the later de novo. Id. In the case at hand, the conclusion turns principally on factual issues, and our review of the record reveals that the Tax Court did not clearly err in deciding those. While other conclusions were possible, the evidence did support the determination that the Venture Inn property, which had been in the corporation, was used by Michael Allen in an exchange with Jackson for the Norem Building, which wound up in the hand of the Allens themselves. Among other things, the whole transaction with Jackson was originally designated as an exchange both in agreements and in the Allens' own tax filings. We, therefore, cannot fault the Tax Court's conclusion that there was a corporate distribution of the Venture Inn and an exchange of that property for the Norem Building.

2. The Allens argue that even if the transfers were properly characterized as an exchange, and even if the Allens did, therefore, receive the Venture Inn as a constructive distribution, the government acted arbitrarily and unreasonably when it used the 1986 sale price of the Norem Building to calculate the 1981 fair market value of the Venture Inn. The Allens contend that the Tax Court erred when it placed the burden on them to prove that the IRS acted unreasonably. Rather, the Allens aver, the IRS should have borne the burden of proving that its methods were reasonable.

"In an action to collect taxes, the government bears the burden of proving that the taxes are owing." Adamson v. Commissioner, 745 F.2d 541, 547 (9th Cir. 1984). However, "[o]nce the government introduces its assessment of tax due, a presumption usually arises that the assessment is correct." Bradford v. Commissioner, 796 F.2d 303, 305 (9th Cir. 1986) (quotation and citation omitted). "[T]his court has made clear . . . that the presumption arises only where some factual basis supports it." Adamson, 745 F.2d at 547; see also Weimerskirch v. Commissioner, 596 F.2d 358, 361 (9th Cir. 1979). That means that "before the Commissioner can rely on [the] presumption of correctness, the Commissioner must offer some substantive evidence showing that the taxpayer received income from the charged activity." Weimerskirch, 596 F.2d at 360. The Commissioner must submit at least some evidence that links the taxpayer to the income in question or to the activity in question before the presumption of correctness can arise. See Paccar; Inc. v. Commissioner, 849 F.2d 393, 400-01 (9th Cir. 1988); United States v. Zolla, 724 F.2d 808, 809 (9th Cir.) ("[N]o presumption of correctness attaches to deficiency determines in which the IRS charges a taxpayer with additional income but provides no factual showing that the taxpayer actually received the income in question."), cert. denied, 469 U.S. 830, 105 S. Ct. 116, 83 L. Ed. 2d 59 (1984); United States v. Stonehill, 702 F.2d 1288, 1293 (9th Cir. 1983), cert. denied, 465 U.S. 1079, 104 S. Ct. 1440, 79 L. Ed. 2d 761 (12984). In this case the Tax Court correctly concluded that the government had introduced sufficient evidence to connect the Allens with the transaction so that the Commissioner enjoyed the presumption of correctness.

The issues, therefore, becomes whether the Tax Court erred when it concluded that the Allens failed to show that the Commissioner acted unreasonably when she used the 1986 sale price of the Norem Building to calculate the 1981 fair market of the Venture Inn. we have said that a taxpayer fails

to meet his burden to demonstrate that the deficiency determination was arbitrary and excessive "when he fails to offer any evidence to rebut the deficiency's presumption of correctness . . . ." Edelson v. Commissioner, 829 F.2d 828, 831 (9th Cir. 1987). In other words, if the taxpayer fails to submit evidence that the deficiency was excessive, the taxpayer has not carried his burden of proving that the deficiency calculation was arbitrary. See Adamson, 745 F.2d at 547-48. In this case, the Allens have not shown what the value of the Venture Inn was, or that there had been any change in the value of the Norem Building. There was no evidence to indicate that the value of the Norem Building had increased on whit or that the exchange was not of properties of equal value at the time. We have required that a taxpayer make that kind of showing. for all this record shows, the Commissioner's valuation was perfectly reasonable.[1] The Tax Court, therefore, correctly concluded that the Allens had the burden and failed to meet it.

3. The Allens next contend that the Tax Court erred when it denied an increase in basis of the corporate stock because of the $75,000 paid to Jackson in furtherance of the exchange plan. The Allens assert that the $75,000 was paid in connection with the lease agreement between TVI and Jackson. But, Michael Allen admitted that there was no documentary evidence that the money was paid in connection with the lease. In fact, the lease agreement did not call for any payment, whereas the Real Estate Exchange Agreement did. The corporation's financial statements, which were prepared by its accountant, do not reflect the payment. We cannot say that the Tax Court clearly erred.

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[1] The Allens' reliance on Helvering v. Taylor, 293 U.S. 507, 55 s. Ct. 287, 79 L. Ed. 623 (1934), is misplaced. There the taxpayer had submitted evidence that showed the valuation of stock during the time he owned it and that it had increased in value after he transferred it. Id., at 511, 55 S. Ct. at 289.

4. The Allens finally assert that they should be entitled to a capital loss of $19,842 in 1981 because, if there was a constructive dividend of the Venture Inn, their stock would now be completely worthless. Assertions, however, are not evidence, and the paucity of the evidence submitted by the Allens precludes a finding of clear error.

AFFIRMED.

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

MICHAEL L. ALLEN; ANN MARIE ALLEN, Petitioners-Appellants, V. COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.	)	No. 94-70490 IRS No. 5567-91 ORDER

Before: BROWNING, D.W NELSON, and FERNANDEZ, Circuit Judges.

The panel has unanimously voted to deny appellants' petition for rehearing. The petition for rehearing is, therefore, DENIED.

Opinion of the Tax Court and related orders

Michael L. Allen, TC Memo 1993-612 -- IRC Sec(s) 301, 1373, 1374
MICHAEL L. ALLEN AND ANN MARIE ALLEN; TC Memo 1993-612, RIA TC Memo ¶93,612, 66 CCH TCM 1690

Case Information
IRC SEC(S): Code Sec. 301, Code Sec. 1373, Code Sec. 1374
Docket/Court: Docket No. 5567-91, Tax Court Memorandum Decision.
Date Issued: December 22, 1993
Tax Year(s): Years 1980, 1981, 1983.
Disposition: Decision for Commissioner.

Headnote 1. Pre-1983 S corp. rules -- constructive <pg 1993-3210> distribution. IRS's determination of taxpayer's adjusted basis in stock and notes of solely owned S corp. for purposes of computing allowable loss for tax year, was sustained. Taxpayer received constructive distribution of S corp.'s assets as dividend income under former IRC §1373(b), as S corp.'s recognized gain from like-kind exchange of assets flowed through to taxpayer as undistributed taxable income (UTI); and, taxpayer's receipt of constructive distribution of property from UTI was treated as return of capital. Taxpayer's basis wasn't increased by pledging land as collateral for loan to S corp.; as taxpayer didn't personally pay on loan, corp. wasn't indebted to him as shareholder. Also, taxpayer failed to prove that payment made to property manager wasn't advance made under exchange agreement, or that IRS didn't already include some additional loans to S corp. in its basis adjustment.

References: Code Sec 301, Code Sec 1373, Code Sec 1374

Syllabus
Official Report

Counsel

Thomas C. Morrison, for petitioners.
Thomas E. Ritter, for respondent.

Opinion

MEMORANDUM FINDINGS OF FACT AND OPINION

GERBER, Judge:

Respondent, by means of a statutory notice of deficiency, determined deficiencies in petitioners' Federal income tax for taxable years 1980, 1981, and 1983 in the amounts of $7,320.96, $157,601.08, and $6,535.80, respectively.

After concessions, the issues for our consideration are: (1) Petitioner husband's adjusted basis in the stock and notes of his solely owned S corporation for purposes of computing his allowable loss for the 1980 tax year; and (2) whether petitioner husband received a constructive distribution of the S corporation's assets and, if so, the tax consequences of the distribution.

FINDINGS OF FACT

Some of the facts have been stipulated and the stipulation of facts and attached exhibits are incorporated by this reference. At the time of the filing of the petition herein, petitioners were married and resided in Columbia Falls, Montana. Petitioners filed joint Federal income tax returns for taxable years 1980,

1981, 1982, and 1983. Petitioners filed amended joint tax returns for taxable years 1982 and 1983. References to petitioner in the singular are to Michael L. Allen.

Beginning in August 1968, and through the years in issue, petitioner was a full-time dentist practicing in Columbia Falls, Montana, and surrounding areas. In 1977, petitioner learned, through friends in Columbia Falls and a banker in Libby, Montana, of property in Libby that was for sale. The property, known as the Venture Inn, operated as a motel, bar, and restaurant. Petitioners traveled approximately 118 miles to Libby to view the property. Petitioner decided to purchase the Venture Inn mainly because he believed that, when the Federal Government's planned dam re-regulation project was initiated in the nearby area, there would be an increased demand for motel accommodations over the next 5 to 7 years.

On April 9, 1977, an Agreement To Buy And Sell was executed between petitioner and the sellers, Robert P. Chapman and Patricia J. Chapman (the Chapmans). On April 21, 1977, petitioner formed a corporation called The Venture Inn (TVI), which remained inactive until January 1, 1978. On April 27, 1977, petitioner purchased the Venture Inn from the Chapmans for $1,250,000. A downpayment of $250,000 was due immediately, with the balance deferred in connection with a Contract for Deed. When he purchased the Venture Inn, petitioner envisioned expanding the facility to meet the anticipated demand for rooms. To facilitate his construction financing, petitioner, in negotiating the purchase, required the Chapmans to subordinate their deferred purchase-money rights.

Petitioner paid the $250,000 downpayment in cash comprised of $60,000 of personal funds, a $90,000 bank loan, and $100,000 borrowed from three of petitioner's friends. On May 3, 1977, the Contract for Deed was recorded through a

Notice of Purchaser's Interest, which effectively made TVI the record owner of petitioner's rights under the Contract for Deed.

TVI filed an election to be treated as an S corporation, effective as of January 1, 1978. Also on that date, petitioner contributed the Venture Inn to TVI in a section 351[Footnote 1] exchange and TVI began operating. Up until this time, petitioner had operated the Venture Inn as a sole proprietorship and reported a loss on his Form 1040 Schedule C for taxable year 1977. Petitioner was at all times the sole shareholder of TVI, which, following petitioner's contribution, was in turn the owner of the Venture Inn. TVI <pg 1993-3211> remained an S corporation throughout the years under consideration. TVI filed Small Business Corporation Income Tax Returns, Forms 1120s, for taxable years 1980, 1981, and 1982.

On October 17, 1978, petitioners acquired an unimproved lot (hereinafter sometimes referred to as parcel B) from Hugh G. and Alice I. Cumming for $30,000. Parcel B adjoins the Venture Inn and was acquired so that the motel could be expanded on its existing site. Petitioners did not transfer ownership of parcel B to TVI. Petitioner believed that retaining direct ownership afforded him a strong negotiating position in the event that the investment proved unsuccessful and the Chapmans attempted to foreclose on the corporate property.

To effectuate their expansion plans, on or about August 1, 1979, petitioners and TVI obtained a $350,000 loan through a Mortgage Participation Agreement. The loan was secured through the U.S. Small Business Administration (SBA) and the Bank of Columbia Falls, Montana. In addition to the mortgage executed by TVI and petitioners, petitioners were required to pledge as collateral two other parcels of their land. Petitioners never paid on the SBA construction loan. In

addition to the SBA construction loan, TVI borrowed money from the First National Bank of Libby, Montana, which was secured by a mortgage on TVI's inventory and equipment. TVI also borrowed funds from petitioner.

After obtaining the financing, a twenty-one room addition was constructed. Sometime after the commencement of the expansion, petitioner discovered that the Federal Government had abandoned its plans for the dam re-regulation project in northwest Montana. As a result of the discontinuation of the Government's project (which was to have brought tourism to the area), the SBA, on August 7, 1980, made an economic dislocation loan of $75,000 to assist TVI.

Paul Jackson (Jackson), one of petitioner's patients, managed motel properties and was involved in putting together exchange transactions. Because of difficulties in managing the motel and cash-flow problems which worsened (due in part to the increase in interest rates on the SBA loan), petitioner contacted Jackson. Among other business ventures, Jackson was involved in the operation of motel properties in the southeastern United States. Jackson's business in Montana was conducted under the name of Imperial Motel Associates, a sole proprietorship which he operated.

Petitioner's initial purpose in contacting Jackson was to see if he would take over the management of the Venture Inn. However, during their first meeting Jackson proposed a like-kind exchange, and petitioner agreed. On September 15, 1980, petitioner paid Jackson $75,000 by check which was deposited into the account of Jackson Farms, an account Jackson maintained in Great Falls, Montana.

On October 1, 1980, TVI and petitioner entered into a Real Estate Exchange Agreement which contemplated a "Starker" like-kind exchange[Footnote 2] between TVI, petitioner and

Jackson. Under the terms of the exchange agreement, TVI and petitioner were to sell, transfer, or exchange the Venture Inn and parcel B (the motel properties) for an agreed value of $1,900,000 together with $75,000 in cash, subject to encumbrances totaling $1,413,000, in exchange for Jackson's acquiring and conveying to petitioners certain farm property in Garfield County, Montana, for a value of $1,340,000 together with storage bins constructed for $75,000. To qualify the transaction as a "Starker" like-kind exchange, Jackson was to locate a purchaser for the motel properties within 2 years whereby the debt assumption by the Venture Inn and petitioners equaled the debt relief. Under the terms of the agreement, petitioner had the right after 1 year to call in the $75,000 advanced cash payment plus annual interest of 12 percent.

The agreement also provided that, commencing October 1, 1980, Jackson was to assume the cash-flow benefits and burdens of operating the Venture Inn. Also on October 1, 1980, in furtherance and support of the Real Estate Exchange Agreement, several other documents were executed by and between the parties, including: Notices of Exchange Interest in Real Estate, Quitclaim Deeds, Bills of Sale, and Warranty Deeds. Attorney John Lence (Lence) held all bills of sale and deeds related to the exchange agreement and related transactions (discussed infra) as an escrow agent.

Jackson, however, was unable to deliver title on the farm property originally contemplated in the exchange agreement. On December 2, 1980, TVI, petitioner and Jackson entered into a lease agreement made retroactive as of October 1, 1980, through and including November 15, 1981, whereby Jackson d/b/a Imperial Motel <pg 1993-3212> Associates, leased the Venture Inn from TVI and petitioner. The lease was prepared by Lence at the request of petitioner and Jackson. The lease was a triple-net lease such that no cash rental was called for, however, Jackson was responsible for all

payments on all outstanding loans on the property as well as all other costs and expenses of operation, including taxes, fees, and other charges of any kind. In addition, Jackson was required to maintain indemnity and casualty insurance on the property.

On November 15, 1981, the day the lease was to expire, petitioner, as president of TVI, executed and delivered to Lence a Warranty Deed and Bill of Sale for the purpose of conveying the Venture Inn and its related chattels to Jackson. On the same day, Berja Investments (a general partnership consisting of Jackson and Joseph T. Berlin) executed and delivered to petitioner a Warranty Deed to property in Bozeman, Montana, (hereinafter referred to as the Norem Building) which it had acquired 3 months earlier on August 14, 1981, from Gilbert T. Rodriguez. The transfer of the Norem Building to petitioner was subject to a lease with Don Norem Chevrolet/Buick, Inc., and total assumed encumbrances of $662,031.96.[Footnote 3] Jackson also gave petitioner a signed promissory note in the amount of $78,000 together with an Agreement Regarding Collateral on that date. The Agreement Regarding Collateral describes the transaction as an exchange of the Venture Inn and parcel B for the Norem Building. Under the terms of the agreement, parcel B was to remain in petitioners' name until Jackson delivered to petitioner a release on the underlying indebtedness of the Venture Inn and evidence that the promissory note had been paid in full. Neither petitioners nor Jackson signed the Agreement Regarding Collateral.

On December 10, 1981, a preliminary title insurance report was issued to Jackson, as a prospective buyer of the Venture Inn, proposing to insure the motel and parcel B, although no title insurance policy was ever issued. On the same day, Jackson entered into a Real Estate Sales Agreement with Henry J. Ostle, Mildred B. Ostle, and Percy Ostle (the

Ostles). The agreement stated that Jackson, as owner of the Venture Inn, sold a 50-percent interest in the Venture Inn to the Ostles for a sales price computed as 50 percent of $1,800,000 allocated between downpayment and assumption of liabilities in the respective amounts of $400,000 and $1,400,000. In accordance with their 50-percent interest, the Ostles made a downpayment of $200,000 and assumed 50 percent of the approximately $1,400,000 of existing encumbrances.

Concurrent with these agreements, Grant Deeds were executed by Jackson giving Henry J. and Mildred B. Ostle a 37.5-percent interest and Percy Ostle a 12.5-percent interest in the Venture Inn and parcel B. In accordance with the sales agreement, a lease agreement was simultaneously entered into by which Jackson leased back the Ostles' 50-percent interest for a period of 5 years for a yearly rental of $24,000, payable semi-annually, payment of all existing and future debt service on the property, and payment of all costs and operating expenses.

On January 20, 1982, Berja Investments and Bear Country Corp.[Footnote 4] entered into an exchange agreement with Harvey J. Parmelee (Parmelee). Under the agreement, in consideration of a $50,000 payment by Parmelee, Berja's 28.32-percent interest in a motel in Iowa and Bear Country's 50-percent interest in the Venture Inn were exchanged for farm and ranchlands in Pondera County, Montana. There is indication that this agreement was implemented. On January 25, 1982, Jackson executed a Grant Deed and Bill of Sale in favor of Parmelee transferring to him a one-eighth interest in the Venture Inn property, parcel B, and the personal property of the Venture Inn.

On February 26, 1982, Jackson filed a petition for protection under chapter 11 of the Bankruptcy Code. Jackson listed all

the debts due by the Venture Inn as his own on the bankruptcy petition. He also listed a three-eighths ownership interest in the Venture Inn as his asset.

On March 30, 1982, Lence, as escrow agent, released all bills of sale and deeds related to the exchange agreement and related transactions and they were recorded.[Footnote 5]
On May 26, 1982, the Chapmans and Jackson entered into a contract whereby the <pg 1993-3213> Chapmans agreed to purchase all real and personal property of the Venture Inn. Under the terms of the contract the Chapmans were to pay $100,000 at closing and to assume the underlying debt as follows:

Chapman contract for deed	$521,660.00
Sea-1st Mortgage	401,504.00
Cumming's contract for deed	26,111.55
Liquor license-SBA security agreement ..	37,000.00
Real estate taxes	58,000.00
SBA improvement loan	350,000.00
SBA direct loan	75,000.00

The contract states that the "Closing to be upon approval by Federal Bankruptcy Judge in Seller's Chapter 11 Reorganization." In addition, among other things, Jackson, as seller, was to secure a release from petitioner of his $78,000 equity claim and note, and a full release of the Ostle and Parmelee interests. From August 16, 1982, through August 30, 1982, various documents were executed unraveling the various transactions regarding the Venture Inn, resulting in the completed transfer of the Venture Inn back to the Chapmans.

The transactions between Jackson and the Chapmans did not disturb petitioner's interest in the Norem Building. Petitioner retained his interest in the Norem Building until 1986 at which

time, following 2 years of negotiations, he sold it to Don and Katherine Norem for $790,000.

As of December 31, 1979, petitioner's basis in his TVI stock was $22,424.25.

Petitioners requested an extension of time to file their 1980 individual return. Petitioners explained the need for an extension as follows: 'Taxpayer was engaged in a motel business that was exchanged pursuant to Section 1031 of the Internal Revenue Code. Additional time is needed to properly reflect deferred gain and carry over basis." Respondent granted petitioners an extension to October 15, 1981. On Schedule E of their 1980 return, filed October 13, 1981, petitioners carried over TVI's 1980 reported loss of $74,520.

When TVI filed its 1981 Small Business Corporation Income Tax Return on October 19, 1982, it reported a taxable loss of $304,751. TVI's 1981 return reflects November 1, 1981, as the date of disposition of all its assets. For taxable year 1981, petitioners again requested and were granted an extension of time to file their return. Petitioners' explanation for this request was as follows: "Taxpayers were involved in a Section 1031 Tax-Free Exchange and additional time is necessary [for] * * * computing basis on acquired property." On that return petitioners' Schedule E reflects November 1, 1981, as the acquisition date of the Norem Building.[Footnote 6] Due to basis limitations, as computed by petitioners, their 1981 return reflected $103,464 of TVI's reported loss.

For taxable year 1981, TVI reported a complete disposition of its assets. For 1982, TVI filed an inconsistent corporate return reflecting a taxable loss of $124,877 in connection with the disposition of its assets. The difference in the losses claimed on the corporate returns for 1982 and 1981 is attributable to additional claimed depreciation on equipment and paving. The

corporate return for taxable year 1982 states that the return for 1981 is to be amended; however, no amended return was ever filed. Under the basis limitations as computed by petitioners, they brought forward a $469 loss on their 1982 individual return.

OPINION

For convenience, we will summarize the relevant facts. Petitioner purchased the Venture Inn in 1977 and transferred it to TVI, a wholly owned S corporation, in 1978. Petitioner deducted losses relating to TVI for the years he claimed it owned the Venture Inn. Petitioner experienced financial difficulties with respect to TVI and, in 1980, contracted with Jackson to exchange the Venture Inn for other property in a section 1031 tax-free transaction. Jackson encountered difficulties in locating and acquiring property suitable to execute the exchange. While Jackson was looking for property, he took over management of the Venture Inn. On November 15, 1981, petitioner and Jackson executed and delivered documents conveying the Venture Inn to Jackson and the Norem Building to petitioner. <pg 1993-3214> After that date, petitioner exercised ownership over the Norem Building and Jackson exercised ownership over the Venture Inn. Jackson even transferred a portion of ownership in the Venture Inn to third parties. In 1982, under threat of repossession, Jackson transferred the Venture Inn back to the owners from whom petitioner had originally purchased it.

Petitioner's Basis and Loss Limitation for 1980

As a general rule, section 1374(a) provides that the net operating loss of an S corporation passes through to its shareholders. However, section 1374(c)(2)[Footnote 7] limits each shareholder's portion of the S corporation's net operating loss to the sum of the adjusted basis of the shareholder's stock and the adjusted basis of any indebtedness of the corporation to the shareholder.

The parties are in agreement that as of December 31, 1979, petitioner's adjusted basis in his TVI Stock was $22,424.25. It is from this date forward that the parties diverge. Respondent determined that TVI's records reflected an increase in notes payable to petitioner from the taxable year ending December 31, 1979, to the taxable year ending December 31, 1980, in the amount of $8,784. Respondent determined that, as of December 31, 1980, petitioner's adjusted basis in his TVI stock was $31,208 by adding the increase in notes to petitioner's adjusted basis. Accordingly, of the $74,520 loss claimed on their 1980 joint return, respondent disallowed $43,312 (total loss claimed of $74,520 - adjusted basis of $31,208 = $43,312). Petitioner bears the burden of proof that respondent's determination is in error. Rule 142(a).

Petitioners contend that as a result of their coparticipation in the $350,000 SBA loan, which they were required to collateralize with personal assets, petitioner is entitled to a stepup in basis for purposes of determining passthrough losses. Petitioner would have us view the transaction as one in which he, with his wife, borrowed $350,000 from the SBA and then constructively loaned the full amount to TVI. Petitioners' argument is neither novel[Footnote 8] nor persuasive. This Court in Estate of Leavitt v. Commissioner, 90 T.C. 206, 211 (1988), affd. 875 F.2d 420 [63 AFTR2d 89-1437] (4th Cir. 1989) restated our holding in Raynor v. Commissioner, 50 T.C. 762, 770-771 (1968) that:

> the fact that shareholders may be primarily liable on indebtedness of a corporation to a third party does not mean that this indebtedness is "indebtedness of the corporation to the shareholder" within the meaning of section 1374(c)(2)(B). No form of indirect borrowing, be it guaranty, surety, accommodation, comaking or otherwise, gives rise to indebtedness from the corporation

to the shareholders until and unless the shareholders pay part or all of the obligation. Prior to that crucial act, "liability" may exist, but not debt to the shareholders. [Citations omitted.]

Petitioner testified that he did not personally pay any amount on the SBA loan. In the absence of that "crucial act" no indebtedness of the corporation to him as a shareholder exists. Accordingly, petitioner is not entitled to an increase in basis in connection with the SBA construction loan.

Petitioner further contends that his $75,000 payment to Jackson on September 15, 1980, was on behalf of TVI to induce Jackson to lease the Venture Inn from TVI while he continued to look for suitable exchange property. Respondent contends that the check represents an advance of the $75,000 cash payment called for under the exchange agreement and, therefore, does not increase petitioner's basis.

Petitioner has failed to carry his burden of proof with respect to the $75,000 payment to Jackson. Unlike the exchange agreement, the lease agreement contains no reference to any such consideration. The financial statement of September 30, 1980, prepared by petitioners' certified public accountant, does not reflect this payment by petitioner as one made on TVI's behalf. In addition, petitioner has not explained why he would have rendered payment in September for a lease that was not entered into until December. Accordingly, petitioner may not increase his basis by this amount. <pg 1993-3215>

Petitioner further contends that his basis should be increased to include additional amounts he loaned to TVI. Petitioners have presented seven checks drawn by petitioner from February to August 1980 payable to TVI in the total amount of $29,283.47. Respondent contends that petitioner has failed to prove the purpose of these checks, the manner in which

they were accounted for on TVI's books and records, or to demonstrate that these amounts were accounted for in the corporate audit. We find petitioner's testimony that during this period he contributed funds to TVI to be credible. However, petitioner has not shown that $8,784 of this amount does not duplicate the basis adjustment already made by respondent. Therefore, petitioner's basis in TVI was $51,708 as of December 31, 1980, and petitioner's portion of TVI's net operating loss in 1980 is limited to this amount. Sec. 1374(c)(2).

Disposition of TVI's Assets

Respondent argues that, on November 15, 1981, petitioner transferred TVI's assets and parcel B for the Norem Building in a like-kind exchange. Respondent contends that, prior to November 15, 1981, TVI constructively distributed its assets to petitioner, the sole shareholder. Because TVI distributed its assets to petitioner, respondent determined that he realized and recognized gain upon the receipt of the assets.

Petitioners contend that the exchange agreement was not consummated. Petitioner further contends that on November 15, 1981, he purchased the Norem Building by agreeing to the assumption of its existing debt, rather than accepting the property under the exchange agreement. It is petitioners' position that TVI did not dispose of its Venture Inn assets until August 30, 1982, when, under threat of repossession, the Venture Inn and parcel B were sold to the Chapmans in exchange for relief from all obligations encumbering the two properties. Petitioner argues, in the alternative, that TVI's assets were disposed of on March 30, 1982, when Lence released the deeds in escrow to Jackson. The parties have stipulated the amount of depreciation, asset classification and basis for TVI's assets as of November 15, 1981, March 30, 1982, and August 30, 1982. Accordingly, we need only determine the manner and date of disposition.

We do not agree with petitioners' characterization of the November 15, 1981, transaction. Petitioner initially may have been reluctant to accept the Norem Building as exchange property, but we are convinced that the exchange occurred. On and after November 15, 1981, petitioner exercised control over and acceded to rights and obligations of the Norem Building. In a similar fashion Jackson controlled the Venture Inn properties. As a result of the November 15, 1981, transfers, petitioner received the Norem property, Jackson received the Venture Inn, and TVI received nothing.

To reach this result, TVI is considered to have constructively distributed its assets to petitioner. Despite petitioner's contrary arguments, the relevant documents and the record reflect an exchange of property as of the 1981 date. Accordingly, petitioner and TVI must recognize any realized gain on the distribution of the assets. We note that petitioner only argued that there was no exchange of property as of November 15, 1981. Petitioner did not contradict respondent's determination of the tax consequences that flowed from that transaction. Having found that there was a constructive distribution on November 15, 1981, we accept respondent's computations.

Section 301 deals with distributions of property made by a corporation to a shareholder with respect to its stock. The amount of the distribution is the amount of money received, plus the fair market value of the other property received. Sec. 301(b)(1)(A). The distribution amount is reduced, but not below zero, by the amount of any liability of the corporation assumed by the shareholder in connection with the distribution. Sec. 301(b)(2)(A). The taxable amount of the distribution is set out in section 301(c), as follows:

(c) Amount Taxable. -- In the case of a distribution to which subsection (a) applies --

(1) Amount Constituting Dividend. -- That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) Amount Applied Against Basis. -- That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) Amount In Excess Of Basis. --

(A) In General. -- Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

Section 316(a) defines a dividend as any distribution of property made by a corporation to its shareholders out of accumulated <pg 1993-3216> earnings and profits or out of current year earnings and profits.

Respondent argues that, as a result of TVI's constructive distribution of its assets to petitioner, TVI distributed property subject to liabilities that exceeded its adjusted basis and TVI must, therefore, recognize gain. Sec. 311(c). This gain flows through to petitioner because it constitutes undistributed taxable income (UTI), in the amount of $147,810, and petitioner takes into income his pro rata share (in this instance -- 100 percent) at the end of the year. Sec. 1373. Under section 1376(a), petitioner's basis is increased by the amount required to be included in gross income under section 1373(b).

Respondent further determined that, in addition to the dividend income under section 1373(b) of $147,810, petitioner received a constructive distribution of property from UTI. Petitioner argues that the fair market value of the TVI assets was less than the liabilities and, therefore, no

property was received. Sec. 301(b)(2)(A). We agree with respondent.

Respondent determined the fair market value of the Venture Inn's assets by reference to the 1986 selling price of the Norem Building of $790,000. Respondent added $1,427,067, the amount of the Venture Inn's liabilities petitioner was relieved of, and reduced that amount by the liabilities encumbering the Norem Building which he assumed, to arrive at her determination that the Venture Inn's assets had a fair market value of $1,555,035. Respondent determined a property distribution of $127,968, the fair market value of the property less its liabilities ($1,555,035 - $1,427,067).

Petitioners contend that the Norem Building had no value greater than the debts encumbering it. Petitioners contend that the Norem Building was a "bad bargain" because of the unfavorable lease terms. At trial, Appeals Officer Anita Teichrow testified as to the methodology used to arrive at respondent's determination. Ms. Teichrow explained that in selecting the 1986 selling price of the Norem Building, respondent selected the most conservative figure from the information available. Petitioner has not shown that respondent's methodology is unreasonable or that the determination is in error. Petitioners, therefore, have not carried their burden on this issue.

Having found that petitioner received a property distribution of $127,968 and a UTI distribution of $147,810, we must determine the tax consequences of the distributions. The notice of deficiency contains respondent's determinations with respect to the corporate income, and the treatment of the income flowing through to petitioner, and the constructive distribution of TVI's assets. Petitioner tried to recharacterize the transaction, but has not shown that these calculations are inaccurate. Respondent determined that petitioner has

dividend income of $147,810 and that the remainder of the distribution is a return of capital.[Footnote 9] Petitioner has not shown that respondent's determination is in error, and respondent's determination is sustained.

Decision will be entered under Rule 155.

Footnote 1
All section references are to the Internal Revenue Code in effect for the years in issue and all rule references are to the Tax Court Rules of Practice and Procedure, unless otherwise indicated.

Footnote 2
So-called Starker exchanges derive their name from Starker v. United States, 602 F.2d 1341 [44 AFTR2d 79-5525] (9th Cir. 1979), wherein it was held that the reciprocal transfer of property need not be simultaneous to defer gain or loss under sec. 1031.

Footnote 3
In the notice of deficiency respondent determined that petitioner assumed liabilities of $622,032.96 in connection with the Norem Building. Based on this mathematical error, respondent in the notice of deficiency adjusted petitioners' income to reflect a $40,000 capital gain, which adjustment respondent now concedes.

Footnote 4
There is little in the record in regard to Bear Country Corp.; however, it is identified in the exchange agreement as a Montana corporation with the location of its principal office being the same as that of Berja Investments. In addition, it, not Jackson, is identified in the exchange agreement as the owner of an undivided 50-percent interest in the Venture Inn.

Footnote 5
The Real Estate Sales Agreement executed on Dec. 10, 1981, between Jackson and Henry and Mildred Ostle and the exchange agreement executed on Jan. 20, 1982, between Berja and Bear County and Parmelee were not recorded.

Footnote 6
The return describes what has been referred to in this opinion as the Norem Building as "Commercial Building-Bozeman".

Footnote 7
Sec. 1374(c)(2) provides as follows:
(2) Limitation. -- A shareholder's portion of the net operating loss of an electing small business corporation for any taxable year shall not exceed the sum of --
(A) the adjusted basis (determined without regard to any adjustment under section 1376 for the taxable year) of the shareholder's stock in the electing small business corporation, determined as of the close of the taxable year of the corporation, (or, in respect of stock sold or otherwise disposed of during such taxable year, as of the day before the day of such sale or other disposition), and
(B) the adjusted basis (determined without regard to any adjustment under section 1376 for the taxable year) of any indebtedness of the corporation to the shareholder, determined as of the close of the taxable year of the corporation (or, if the shareholder is not a shareholder as of the close of such taxable year, as of the close of the last day in such taxable year on which the shareholder was a shareholder in the corporation).

Footnote 8
See also Putnam v. Commissioner, 352 U.S. 82 [50 AFTR 502] (1956); Underwood v. Commissioner, 535 F.2d 309 [38 AFTR2d 76-5476] (5th Cir. 1976), affg. 63 T.C. 468 (1975); Perry v. Commissioner, 47 T.C. 159 (1966), affd. 392 F.2d 458 [21 AFTR2d 1003] (8th Cir. 1968); Borg v. Commissioner, 50 T.C. 257 (1968).

Footnote 9

Respondent concedes that the remaining $19,842 in basis may be allowable as a capital loss at some point. However, because of questions of timing and other factors, respondent has not allowed the loss to petitioners in the years in issue. Petitioner argues that any loss attributable to the stock would be a sec. 1244 loss. Petitioners have not shown that the stock was issued under a written plan or that the other regulatory requirements were met. Accordingly, petitioner's stock does not qualify as sec. 1244 stock.

UNITED STATES TAX COURT
Washington, D.C. 20217

MICHAEL L. ALLEN AND	)	
ANN MARIE ALLEN,	)	
Petitioners,	)	
V	)	
	)	Docket No. 5567-91
COMMISSIONER OF	)	
INTERNAL REVENUE,	)	
Respondent.	)	

ORDER AND DECISION

The Court issued its opinion in this case on December 22, 1993 (T.C. Memo. 1993-612), and the parties were to provide a computation of the deficiencies under Rule 155 of this Court's Rules of Practice and Procedure. Respondent's proposed computations were filed April 8, 1994, and petitioners filed a separate proposed computation on April 28, 1994. Both parties arrived at the same dollar amount for the income tax deficiency for each of the three taxable years. The parties differ, however in the nomenclature used to describe underlying matters. It appears that the jockeying by the parties concerns the basis petitioners will have in property for purposes of future tax recognition. Finding it unnecessary to decide which parties' approach is correct for purposes of entering a decision for the taxable years 1980, 1981, and 1983, we adopt neither set of calculations, but only the amount of the deficiency for each year.

Pursuant to the Court's opinion in T.C. Memo. 1993-612 and accepting the amount of deficiency agreed to by the parties for each tax year, it is

ORDERED and DECIDED that there are deficiencies in income tax due from petitioners for the taxable years 1980, 1981, and 1983 in the amounts of $389.00, $129,715.80, and $6,535.00, respectively.

(Signed) Joel Gerber

Joel Gerber
Judge

Entered: MAY 18 1994